

Testimony of John D. Colombo^{*}
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I. Introduction

In a 2002 article, Stephanie Strom of the New York Times reported that in the previous year, the Metropolitan Museum of Art had revenues of \$96.6 million from its shops, restaurants and parking garage, almost three times the revenue generated by admissions and membership fees.¹ That same year, the Yale School of Management announced that it had secured grants totaling \$4.5 million from the Pew Charitable Trusts and the Goldman Sachs Foundation to establish a program to help charities develop business plans for entering commercial markets.² A 2003 article in Forbes reported on the wide-ranging business activities of “megachurches”;³ a 2001 article in the Wall Street Journal struck a similar note, commenting on how churches across the country were opening restaurants, Starbucks franchises and private gyms.⁴ Even the academic world has noticed the trend: in 1998, economist Burton Weisbrod and several of his colleagues published an entire book about the growing commercial activities of charities,⁵ and the Urban Institute Press published another book on the subject in 2009.⁶

^{*} Albert E. Jenner, Jr. Professor of Law, University of Illinois. This written testimony is largely copied from my article *Reforming Internal Revenue Code Provisions on Commercial Activity by Charities*, 76 FORDHAM L. REV. 667 (2007).

¹ Stephanie Strom, *Nonprofit Groups Reach for Profits on the Side*, New York Times, March 17, 2002.

² *Yale School of Management Receives Twin Grants Totaling \$4.5 Million from the Goldman Sachs Foundation and the Pew Charitable Trusts to Foster Business Growth Among Nonprofit Organizations*, SOM NEWS, Feb. 8, 2002.

³ “World Changers Ministries, for instance, operates a music studio, publishing house, computer graphic design suite and owns its own record label. The Potter’s House also has a record label, as well as a daily talk show, a prison satellite network that broadcasts in 260 prisons and a twice-a-week Webcast. New Birth Missionary Baptist Church has a chief operating officer and a special effects 3-D Web site that offers videos-on-demand. It publishes a magazine and holds Cashflow 101 Game Nights. And Lakewood Church, which recently leased the Compaq Center, former home of the NBA’s Houston Rockets, has a four-record deal and spends \$12 million annually on television airtime.” Luisa Kroll, *MegaChurches, Megabusinesses*, available at http://www.forbes.com/2003/09/17/cz_lk_0917megachurch.html.

⁴ Elizabeth Bernstein, *Holy Frappuccino!*, WALL ST. J., Aug. 31, 2001 at W1.

⁵ TO PROFIT OR NOT TO PROFIT (Burton Weisbrod ed., 1998).

⁶ Joseph J. Cordes and Eugene Steurle, NONPROFITS AND BUSINESS (Urban Institute Press 2009).

Charities are not just conducting more commercial activities themselves, however. It is increasingly common to find charities engaged in a variety of economic activities through for-profit subsidiaries, joint-venture partnerships and contractual arrangements. The health care sector is perhaps the most visible in its use of complex structures, but they are also found in education and other traditionally-charitable activities.⁷

Commercial activity by charities, therefore, seems to be an entrenched and growing phenomenon. Yet the income tax rules surrounding commercial activity are confused and contradictory, based on regulations issued in 1959 that no longer serve either tax policy or the exempt organizations community.

⁷ One of the more famous recent cases illustrating a complex structure was *Geisinger Health Plan v. Comm'r*, 100 T.C. 394 (1993). As explained by the Tax Court:

Petitioner [GHP] owned and operated a health maintenance organization (HMO) under the Pennsylvania Health Maintenance Organization Act, Pa. Stat. Ann. tit. 40, secs. 1551-1567 (Supp. 1991). Petitioner was one of nine related organizations. The eight other organizations, referred to collectively as the Geisinger system and described below, were the Geisinger Foundation (the foundation), Geisinger Medical Center (GMC), Geisinger Clinic (the clinic), Geisinger Wyoming Valley Medical Center (GWV), Marworth, Geisinger System Services (GSS), and two professional liability trusts. Each of these eight entities was recognized by the Internal Revenue Service as an exempt organization described in sections 170(b)(1)(A)(iii), 501(c)(3), and 509(a)(1).

....

The foundation controlled petitioner and the other entities in the Geisinger system, as well as three for-profit corporations. The foundation had the power, under the articles of incorporation and bylaws of petitioner, GMC, GWV, GSS, the clinic, and Marworth, to appoint the corporate members of those entities, who in turn elected their respective boards of directors. The foundation's board of directors was composed of civic and business leaders who were representative of the general public in northeastern and north-central Pennsylvania and were public-spirited citizens. The foundation raised funds for the Geisinger system's numerous charitable purposes and activities.

Id. at 395-96.

Although a large percentage of complex structures come from the health care sector, they exist in other sectors as well. See, e.g., *Priv. Ltr. Rul. 95-06-046* (Nov. 17, 1994) (ruling on a case in which a business league exempt under section 501(c)(6) established first- and second-tier subsidiaries to construct and operate a golf course); *Gen. Couns. Mem. 39,776* (Jan. 4, 1989) (analyzing a situation in which an exempt university controlled a section 501(f) organization that in turn controlled a taxable subsidiary). See generally FRANCES R. HILL & DOUGLAS M. MANCINO, *FEDERAL AND STATE TAXATION OF EXEMPT ORGANIZATIONS*, chapter 27 (2006) (discussing exempt organizations' use of complex structures of related exempt and taxable entities); James J. McGovern, *The Use of Taxable Subsidiary Corporations by Public Charities – A Tax Policy Issue for 1988*, 38 *TAX NOTES* 1125 (1988) (discussing use of taxable subsidiaries by exempt organizations).

II. The Current Tax Rules⁸

Federal tax rules regarding commercial activity involve two main issues and two subsidiary ones.⁹ The first main issue is whether the activity jeopardizes the charity's tax exemption under Section 501(c)(3) of the Internal Revenue Code ("Code"). Commentators have referred to this first issue as the "commerciality doctrine" or "commerciality limitation" on exempt status.¹⁰ The second main issue is whether, if commercial activity does not jeopardize exemption, it nevertheless should be taxed. This issue is covered by the Unrelated Business Income Tax (UBIT) in sections 511-514 of the Code that has been with us since 1950.

To illustrate these main issues, suppose that I start a charity whose purpose is to run a soup kitchen for the homeless. The revenue for this charity comes exclusively from donations. Provided that this organization complies with other requirements of exemption, there is no question it qualifies as an exempt charity under 501(c)(3), with both a primary purpose and activity dedicated to relief of the poor. Now suppose that I decide that I could expand my soup kitchen operation if I had more revenue. So I finance the acquisition of a small manufacturing facility to manufacture and can chicken soup that I then sell through commercial channels with the intent of using the profits generated to expand my soup kitchen operation. Two questions arise: does the "commercial" soup manufacturing/sales operation cause my organization to lose its exempt status? If not, must I nevertheless pay tax on the profits from the soup sales?

The two subsidiary issues are (1) whether commercial activity undertaken by entities related to a charity (e.g., a subsidiary of a charitable parent, a sibling for-profit corporation or a partnership in which a charity is a partner) will be "imputed" to the exempt entity for purposes of determining their tax-exempt status and (2) how the IRS uses the "private benefit" doctrine to police economic transactions with for-profit entities or individuals outside the charitable class. This part of the article describes the current doctrine applicable to each of these issues. Returning to my soup hypothetical, suppose that instead of the charitable organization operating the soup manufacturing, it does so through a controlled

⁸ Parts of this section are copied or adapted from John D. Colombo, *Commercial Activity and Charitable Tax Exemption*, 44 WM. & MARY L. REV. 487, 491 (2002) (hereafter *Commercial Activity*) and John D. Colombo, *Regulating Commercial Activity by Exempt Charities: Resurrecting the Commensurate-in-Scope Doctrine*, 39 EXEMPT ORG. TAX REV. 341 (2003) (hereafter *Commensurate-in-Scope*).

⁹ See generally, Colombo, *Commercial Activity*, *supra* note 8, at 491 (2002); JAMES J. FISHMAN AND STEPHEN SCHWARZ, *NONPROFIT ORGANIZATIONS* 567-72 (4th ed. 2010).

¹⁰ Colombo, *Commercial Activity*, *supra* note 7, at 491; FISHMAN AND SCHWARZ, *supra* note 7, at 572; BRUCE R. HOPKINS, *THE LAW OF TAX-EXEMPT ORGANIZATIONS* 99-114 (10th ed. 2011).

for-profit subsidiary. Does this change the analysis? What if instead my charity enters into a partnership with a commercial soup manufacturer to market a line of Colombo’s Soup Kitchen soups? Unfortunately, the answers to all these questions are extremely difficult under existing law.

A. *The Commerciality Limitation vs. the UBIT*

Though Section 501(c)(3) states that an organization will qualify for exemption only if it is “organized and operated *exclusively*” for a charitable purpose, the statute has almost never been interpreted literally. As early as 1924, the Supreme Court held that a religious order would not lose exemption because of its limited sales of wine and chocolate.¹¹ Over time, this and subsequent cases established what was known as the “destination of income” test for exemption: an organization could engage in unlimited amounts of commercial activity as long as the revenues from that activity were used for charitable purposes.¹² Even organizations whose only activity was running a commercial business was exempt if it paid over its revenues to a charity.¹³

The destination of income test was overruled by Congress (at least in part) in 1950, when it passed the unrelated business income tax and prohibited exemption for “feeder” organizations.¹⁴ These laws made revenues from commercial activities that were unrelated to charitable purposes taxable, and also prohibited exemption for the entity whose sole activity was operating a commercial business, even if the revenues were paid over to charity.¹⁵ But Congress said nothing in the UBIT and related legislation about whether commercial activity by an organization that otherwise had a bona-fide charitable purpose should affect exemption. One could argue, in fact, that the adoption of the UBIT was an implicit blessing for charities to engage significant amounts of commercial

¹¹ *Trinidad v. Sagrada Orden de Predicadores de la Provincia del Santissimo Rosario de Filipinas*, 263 U.S. 578 (1924).

¹² Colombo, *Commercial Activity*, *supra* note 8, at 498-99; FISHMAN & SCHWARZ, *supra* note 9, at 570-72; HOPKINS, *supra* note 10, at 103-104; HILL AND MANCINO, *supra* note 7, ¶ 21.01 at page 21-4.

¹³ *E.g.*, *C.F. Mueller Co. v. Commissioner*, 190 F.2d 120 (3d Cir. 1951) (Corporation that made macaroni exempt because revenues were paid to New York University’s law school).

¹⁴ I.R.C. §§ 502, 511-514. A “feeder” is an entity that operates a commercial business but is obligated to pay the net revenues of that business over to an exempt charity. *See* FISHMAN AND SCHWARZ, *supra* note 9, at 588-589.

¹⁵ Colombo, *Commercial Activity*, *supra* note 8, at 500; FISHMAN & SCHWARZ, *supra* note 9, at 570-572; HOPKINS, *supra* note 10, at 103-104; HILL AND MANCINO, *supra* note 7, at ¶ 27.04.

activity, since unrelated activity now would be taxed and related activity (presumably) was not viewed as a problem.¹⁶

The final regulations adopted by the IRS in 1959, however, are confusing. The UBIT uses a “relatedness” test for determining taxability. Under the UBIT, commercial activity is taxable if it is not “substantially related” to the organization’s exempt purpose.¹⁷ According to the regulations implementing the UBIT, an activity is “substantially related” if “the principal purpose of such trade or business is to further (other than through the production of income) the purpose for which the organization is granted exemption.”¹⁸ The key phrase in this regulation is the parenthetical “other than through the production of income.” That is, it is clear from the UBIT regulations that a commercial activity whose purpose is simply to provide a revenue stream for charitable activities is not “related” and therefore is taxable. Instead, “relatedness” is a functional concept focused on how the underlying nature of the commercial activity integrates with the exempt entity’s charitable purpose, not on where the revenues from the commercial activity end up. But these regulations say nothing about whether commercial activity, related or unrelated, should affect exempt status.

With respect to the exempt status issue, Regulations §1.501(c)(3)-1(b)(1)(i) states that an exempt charity’s organizational document (e.g., articles of incorporation or trust agreement) may not empower it to “engage, other than as an insubstantial part of its activities, in activities which in themselves are not in furtherance of one or more exempt purposes.”¹⁹ A couple of paragraphs later, the regulations warn that an organization will fail to qualify for exemption “if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.”²⁰ But an even later part of the regulations (1.501(c)(3)-1(e)) states that

¹⁶ Indeed, Professor Ethan Stone has argued that the UBIT was largely a “border patrol” measure (a phrase first used by Professor John Simon in describing the various tax rules applicable to exempt organizations) designed to keep charities from wandering too far from traditional “good works” that defined the charitable sector. Ethan Stone, *Adhering to the Old Line: Uncovering the History and Political Function of the Unrelated Business Income Tax*, 54 EMORY L.J. 1475 (2005). Stone’s analysis supports the proposition that “related” business activity should have no bearing on exempt status, and that Congress believed it adequately responded to the “threat” of unrelated activity by taxing it, rather than revoking exemption because of it. The counter-argument here is that if Congress really did view the UBIT as mostly a “border-patrol” measure, then perhaps excessive “unrelated” business should cause loss of exemption due to inappropriate border-crossing.

¹⁷ I.R.C. § 513(a). For a more extensive discussion of the UBIT rules, see HILL AND MANCINO, *supra* note 7 at chapter 22; HOPKINS, *supra* note 10 at chapter 23

¹⁸ Treas. Reg. § 1.513-2(a)(4).

¹⁹ Treas. Reg. §1.501(c)(3)-1(b)(1)(i).

²⁰ Treas. Reg. §1.501(c)(3)-1(c)(1).

an organization may qualify for exemption even if “it operates a trade or business as a substantial part of its activities, if the operation of such trade or business is in furtherance of the organization’s exempt purpose and if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business”²¹ It appears from these regulations, therefore, that the two key concepts in determining the effect of commercial activity on exempt status (as opposed to whether the commercial activity is taxable under the UBIT) is when an activity is “substantial” and when an activity can be said to be “in furtherance of” an exempt purpose. The regulations, particularly Regulations §1.501(c)(3)-1(e), seem to say that unrelated business activities that are “in furtherance of” can be substantial without endangering exempt status; activities that are not “in furtherance of,” however, must be insubstantial in order to retain exemption.

The regulations, therefore, seem to set forth a fairly straightforward linear analysis regarding the effect of commercial activity on exempt status. This three-step analysis is as follows. First, one must identify the organization’s charitable purpose (if any). Second, one must analyze whether a particular noncharitable activity (e.g., a commercial activity) is “substantial” in comparison to other activities of the organization in question. Third, if the commercial activity is substantial, then one must analyze whether that substantial commercial activity is “in furtherance of” the organization’s charitable purpose.

The problem is that the regulations under 501(c)(3) do not tell us anything about when a commercial activity is “substantial” or when it is or is not considered “in furtherance of” an exempt purpose. With respect to the former issue, a number of questions arise. Is “substantial” measured quantitatively or qualitatively? If the former, what quantitative measures are relevant, and are they measured absolutely or relative to charitable activity? If absolute, how much activity is “substantial”? If relative, do we compare the gross expenditures on the commercial activity vs. the charitable activities? Gross revenues for each? Number of employees (or volunteers) in each activity? The amount of time spent by the employees/volunteers on each activity? The regulations say nothing about this.²²

²¹ Treas. Reg. §1.501(c)(3)-1(e).

²² Case law is equally useless. The closest we have to a definition of “substantial” is a case that dealt with the concept under the lobbying limitation (“no substantial part” of an exempt organization’s activities may be lobbying). In *Christian Echoes National Ministry, Inc. v. United States*, 470 F.2d 849 (10th Cir. 1973) the court refused to measure “substantiality” by a mathematical test: “A percentage test to determine whether the activities were substantial obscures the complexity of balancing the organization’s activities in relation to its objectives and circumstances.” This interpretation of “substantial” (admittedly for a different purpose – lobbying, rather than commercial activity) suggests that the question of substantiality is dependent on how important the activity in question is to the other charitable activities carried on (if any). Quantitative measures might inform “importance” of course, but would not be determinative.

With respect to the interpretation of “in furtherance of,” the regulations and case law are also completely silent. One possible interpretation of the regulations is that “in furtherance of” is equivalent to “substantially related” under the UBIT. Or put the opposite way, one might conclude that any “unrelated” activity under the UBIT is *not* “in furtherance of,” and any “substantial” amount of unrelated commercial activity therefore creates exemption problems.²³ Certainly, one cannot see “related” activity as creating exemption problems; if an activity is related for UBIT purposes, then by definition it must functionally advance the organization’s exempt purpose, and hence must be viewed as being “in furtherance of” that purpose. But the contrary proposition (that “unrelated” activity automatically is *not* “in furtherance of”) is not necessarily true. In fact, if this proposition were correct, then the statement in Regulations § 1.501(c)(3)-1(e) quoted above that an organization may operate a business as long as the “primary purpose” is not carrying on an unrelated business makes no sense. If *any* “unrelated” business were viewed as *not* being “in furtherance of,” then any unrelated business that was “substantial” would cause an organization to lose exempt status. A “substantial” business is presumably well short of one that is a “primary purpose”; therefore, the reference in Regulations § 1.501(c)(3)-1(e) to an organization losing exemption when an unrelated business becomes its primary purpose would be completely meaningless, because any “substantial” unrelated business would cause loss of exemption even if that business was not the “primary purpose.”

The only sensible harmonization of these regulations, therefore, is that in enacting the UBIT, Congress did not intend to alter the “destination of income” test for the purpose of granting exemption to an entity in the first instance.²⁴ That is, unrelated business activity is taxed, but if the proceeds are used to support charitable activities, the organization in question is still entitled to an exemption (for its other income). It is only when the operation of the unrelated business becomes the entity’s “primary purpose” that it loses exempt status, because at that point (obviously) the entity’s “primary purpose” is no longer charitable. Put another way, “in furtherance of” has two meanings: commercial activity may be “in furtherance of” an exempt purpose by being functionally related to that purpose (for example, the music school of an exempt university puts on concerts for which it charges admission fees) *or* by being a source of revenue to expand charitable outputs.

²³ See Jessica Pena & Alexander L.T. Reid, *A Call for Reform of the Operational Test for Unrelated Commercial Activity in Charities*, 76 N.Y.U. L. REV. 1855, 1864 (2001).

²⁴ See Ellen P. Aprill, *Lessons from the UBIT Debate*, 45 TAX NOTES 1105, 1107 (1989).

Early interpretations of the regulations by the IRS seemed to support the notion that even substantial unrelated business activity would not endanger exempt status as long as the revenues from that activity (which, of course, would be taxable under the UBIT) were used for charitable purposes. In Rev. Rul. 64-182,²⁵ the IRS considered a case in which an exempt organization derived its revenues largely from renting space in a commercial office building; the revenues were used to make grants to other charitable entities. Concluding that the rental activity was “unrelated” for purposes of the UBIT, the Service nevertheless ruled that the organization was entitled to retain its exempt status as an organization described under section 501(c)(3) because it was carrying on a charitable program “commensurate in scope” with its financial resources.²⁶

The background to the 1964 revenue ruling, however, is more revealing than the ruling itself in interpreting the “commensurate-in-scope” language. Prior to approving the 1964 revenue ruling, the General Counsel’s office referred the issue in the proposed ruling to the Exempt Organizations Council for analysis. The Council’s analysis, attached to General Counsel’s Memorandum 32689,²⁷ contained two primary conclusions. First, “the amount of expenditures of an organization for charitable purposes must be taken into consideration in equating business activities with charitable activities” under the primary purpose test of reg. section 1.501(c)(3)-1(c). Second, if after considering such expenditures, “an organization is shown in fact to be carrying on a real and substantial charitable program reasonably commensurate in financial scope with its financial resources and its income from its business activities and other sources,” then the organization would be considered as having a charitable primary purpose.²⁸ According to the Council’s analysis, the primary purpose test “becomes a test of whether there is a real, bona fide or genuine charitable purpose . . . and not a mathematical measuring of business purpose as opposed to charitable purpose.”²⁹ Or in other words, (1) “primary purpose” cannot be determined by a mathematical comparison of size based upon number of employees, space utilized, or similar factors – there is no specific mathematical limit on unrelated business activities and (2) the dedication of net revenues from an unrelated business to charitable purposes is a necessary part of the analysis of the effects of unrelated business activity on tax exemption, and such dedication itself is evidence that an organization’s “primary purpose” is charitable. On the other hand, the Council indicated that when the operation of a substantial unrelated business did not result in cross-subsidization, the organization was no longer being operated primarily

²⁵ Rev. Rul. 64-182, 1964-2 C.B. 186.

²⁶ *Id.*

²⁷ Gen. Couns. Mem. 39862, 1963 WL 62497 (IRS GCM) (Oct. 9, 1963).

²⁸ *Id.*

²⁹ *Id.*

for charitable purposes.³⁰ By implication, the Council’s analysis seemed to be that dedication of revenues from commercial activity to charitable activities was “in furtherance of” a charitable purpose.

A later General Counsel’s Memorandum further illuminated the “commensurate in scope” idea. This memo provides perhaps the best analysis of the doctrine and related issues of any IRS document. Reaffirming the original view of the Exempt Organizations Council that there were no “bright line” tests in determining whether unrelated business activity was consistent with exempt status, the memo stated,

[A]side from express statutory limitations on business activity, such as section 502 and the newly enacted provisions relating to private foundations, there is no quantitative limitation on the “amount” of unrelated business an organization may engage in under section 501(c)(3), other than that implicit in the fundamental requirement of charity law that charity properties must be administered exclusively in the beneficial interest of the charitable purpose to which the property is dedicated.

...
[F]or some time now it has been increasingly apparent that our earlier approach to the problem of permissibility or nonpermissibility of business activities of charities has been based on a misconception that somehow in the enactment of the provisions for exemptions of charities from income tax, Congress intended an implied restriction on the extent of their engagement in business activities. In the years past, the Service sought by ruling and by litigation to deny the right of charities to engage in business, insisting that somewhere, somehow in the enactment of the exemption provisions Congress must have intended to limit the classification of exempt charities to those charities not engaging to any substantial extent in commercial endeavors.

Exhaustive research of legislative history from the earliest enactment of the charitable provisions of our income tax laws fails to provide support for such proposition. To the contrary, the evidence is clear that the first provision for exemption of charities from imposition of tax under the Corporation Excise Tax of 1909,

³⁰ As summarized by the Counsel's office in GCM 34682, 1971 IRS GCM LEXIS 38 (Nov. 17, 1971) “the Council's supporting Appendix also indicated that, aside from the 'primary purpose' requirement of the regulations, the better logic in cases in which the business activity does not in fact provide any significant funds for charitable use is that the organization is not being operated exclusively for charitable purposes.”

from which the present income tax exemption provisions derive, was accompanied not by any intention to limit exemption to charities not engaged in business, but an intention to assure exemption of certain charities that were engaged in business.³¹

The memo also addressed the issue regarding what should happen in cases in which the operation of an unrelated business either produced no profit to subsidize charitable activities or in which the profit was purposely reinvested to grow the unrelated business, as opposed to dedicated to expanding charitable outputs. As to the former case, the memo agreed with the original position of the Council that “the better logic in cases in which the business activity does not in fact provide any significant funds for charitable use is that the organization is not being operated exclusively for charitable purposes.”³² With respect to the latter case, the memo observed,

We think that if an organization devotes its resources to business use which produces a reasonable return on the investment, but refuses to apply any significant part of its profits or resources to any charitable program and the condition prevailed for an unwarranted long time, a prima facie case could be made out that the organization is not administering its properties exclusively in the beneficial interest of charity since it is neither accomplishing any short range or any long range charitable purpose in respect to the beneficial use of its properties.³³

The memo cautioned, however, that each such case would need to be resolved on its particular facts and circumstances.

Despite what seems to be the clear linear analysis mandated by the regulations, the IRS and courts seem to universally ignore this analysis (particularly the “in furtherance of” question) in analyzing cases. Instead, the IRS litigating positions and case law seems largely to concentrate on whether a particular activity has a “commercial hue” and if so, whether it is “substantial.” Positive answers to these questions generally lead to loss of tax exemption, though even here the analysis is variable. No one seems interested in asking the “in furtherance of” question that is clearly posed in the regulations. The result has been a legal morass.

³¹ Gen. Couns. Mem. 34682, 1971 IRS GCM LEXIS 38, *26-*29 (Nov. 17, 1971).

³² Id. at *18.

³³ Id. at *23-24.

For example, in *Scripture Press Foundation v. U.S.*,³⁴ the taxpayer, Scripture Press, was formed primarily to improve the quality of teaching texts for protestant Sunday schools.³⁵ Soon the company found itself highly successful in preparing and selling a variety of religious literature, accumulating over \$1.6 million in surplus earnings by 1957.³⁶ As a result, the IRS revoked exempt status for the organization, claiming that it in effect was nothing more than a for-profit publisher and hence no longer was operated primarily for charitable purposes. The Claims Court agreed with the Service, noting that Scripture Press priced its products similarly to for-profit competitors and amassed significant profits.³⁷ Though it had an educational program aimed at promoting and expanding Sunday School instruction, the court found that expenditures on educational activities were “unaccountably small” in comparison to the surplus that Scripture Press accumulated annually.³⁸ Accordingly, the court concluded that Scripture Press was not operated “primarily” for charitable purposes.³⁹ Subsequently, the Tax Court and federal district courts upheld the IRS’s revocation of exemption in a number of other publishing cases.⁴⁰

As a result of *Scripture Press* and subsequent cases, by the early 1980's the Tax Court had developed the view that an organization that conducted a significant activity with a “commercial hue” risked losing exempt status. Factors which painted an activity with this impermissible “hue” included the presence of substantial overall profits; using commercial pricing methods with substantial net profit margins and competing with for-profit firms in the same sector.⁴¹ In 1991, the Seventh Circuit in *Living Faith v. Commissioner* adopted this basic analysis in the context of an organization affiliated with the Seventh-day Adventist Church

³⁴ 285 F.2d 800 (Ct. Cl. 1961), cert. denied, 368 U.S. 985 (1962).

³⁵ *Id.* at 803.

³⁶ *Id.* at 804.

³⁷ *Id.* at 804-05.

³⁸ *Id.*

³⁹ *Id.* at 806.

⁴⁰ *Fides Publishers Ass’n v. United States*, 263 F. Supp. 924 (N.D. Ind. 1967); *Elisian Guild, Inc. v. United States*, 292 F. Supp. 219 (D. Mass. 1968), *rev’d*, 412 F.2d 121, 125 (1st Cir. 1969); *Incorporated Trustees of Gospel Worker Society v. United States*, 510 F. Supp. 374, 381 (D.D.C. 1981), *aff’d*, 672 F.2d 894 (D.C. Cir. 1981); *Presbyterian & Reformed Publishing Co. v. Comm’r*, 70 T.C. 1070 (1982), *rev’d* 743 F.2d 148 (3d Cir.1984).

⁴¹ *Presbyterian & Reformed Publishing v. Commissioner*, 70 T.C. 1070, 1083, *aff’d*, 743 F.2d 148 (3d Cir. 1982).

that operated vegetarian restaurants and health food stores, ostensibly to advance church doctrine relating to diet.⁴² In reviewing a Tax Court opinion denying exempt status to the organization, the Seventh Circuit identified several factors leading to a conclusion that the organization violated the commerciality doctrine. These included (1) direct competition with commercial firms, including similar locations (in shopping centers) and similar hours of operation; (2) a pricing structure designed to produce a profit; (3) extensive advertising and use of commercial advertising materials; and (4) a lack in the record of any showing of donations to the organization or significant “relief of the poor.”⁴³

This analysis, however, is not consistent with the IRS’s own regulations. Take *Scripture Press* itself. The proper analysis of this case should have been to ask first whether Scripture Press had a charitable purpose. Given that its stated purpose was to advance religion via religious publishing, it clearly had a religious charitable purpose per Section 501(c)(3). Next, we would ask whether its commercial activities in pursuing that purpose (publishing religious books) were substantial; the clear answer in this case is yes, given that this was essentially all the organization did. We would then follow with the third, critical question completely ignored in the *Scripture Press* litigation, which is whether the publishing activity was “in furtherance of” the religious charitable purpose. I cannot see how one could conclude that religious publishing is not “in furtherance of” a religious purpose – in fact, one could make an extremely strong argument that religious publishing is “substantially related” under the UBIT, given the centrality of the publishing activity to achieving the charitable purpose of advancing or proselytizing religion. In other words, in analyzing *Scripture Press*, the IRS ignored its own regulations, and the courts followed like children to the pied piper.

On the other side of the ledger, in 1984 the Third Circuit reversed the revocation of exempt status for a religious publisher in *Presbyterian & Reformed*

⁴² *Living Faith, Inc. v. Commissioner*, 950 F.2d 365, 367 (7th Cir. 1991) (“According to its articles of incorporation, Living Faith was established for the purpose of keeping with the doctrines of the Seventh-day Adventist Church. . . . Good health, according to Seventh-day Adventists, promotes virtuous conduct, and is furthered by a vegetarian diet and abstention from tobacco, alcohol, and caffeine.”)

⁴³ *Id.* at 373-75. An even more recent case (decided literally weeks ago) is *Asmark Institute, Inc. v. Commissioner*, No. 11-1553 (6th Cir. 2012). In this case, the Sixth Circuit used a “commercial hue” analysis to conclude that an organization which provided consulting services to farms and agribusinesses on a fee-for-service basis was not an exempt charity under 501(c)(3). The court’s one-page analysis of the commercial activity issue (on page 10 of the slip opinion) completely ignores the three-step analysis set forth above. While I suspect the result in the case is correct, it would be nice if courts and the IRS would occasionally engage in some actual reading of the law – particularly when the law is the IRS’s own regulations!

Publishing v. Commissioner,⁴⁴ a case substantially similar to *Scripture Press*. The taxpayer in *Presbyterian & Reformed Publishing* was a highly profitable nondenominational religious publisher that priced its products at market. Though the Tax Court upheld an IRS revocation of exempt status on the ground of impermissible commercial hue based primarily on the large profits generated by the taxpayer's publishing business,⁴⁵ the Third Circuit reversed, noting that "success in terms of audience reached and influence exerted, in and of itself, should not jeopardize the tax-exempt status of organizations that remain true to their stated goals."⁴⁶ A charitable organization, according to the Third Circuit, should be able to make money to expand its audience and influence, and doing so does not make the organization any less charitable.

Similarly, the Tax Court itself approved exemption in several "resale shop" cases - situations in which a nonprofit enterprise primarily operated a business selling crafts produced by a particular group. In the late 1970's, for example, the Tax Court approved exemption for an organization that imported, purchased and sold artist's crafts,⁴⁷ an organization that purchased and sold products manufactured by blind individuals,⁴⁸ and an organization that operated two public art galleries.⁴⁹ A Federal appellate court also reversed a lower court ruling upholding a revocation of exemption on commerciality grounds when the taxpayer, a publishing company, showed that it had no "operational profits."⁵⁰

Even the IRS itself has approved charities engaging in activities with decidedly commercial hues - for example, hospitals and educational organizations can operate health clubs that charge fees similar to for-profit competitors without

⁴⁴ 743 F.2d 148 (3d Cir. 1984)

⁴⁵ 79 T.C. 1070 (1982).

⁴⁶ *Id.* at 158.

⁴⁷ *Aid to Artisans, Inc. v. Comm'r*, 71 T.C. 202 (1978). The organization claimed that its charitable purposes were (1) "helping disadvantaged artisans in poverty stricken countries to subsist and to preserve their craft; and (2) furnishing services to tax-exempt museums by providing museum stores with representative handicrafts from disadvantaged countries." *Id.* at 209.

⁴⁸ *Industrial Aid for the Blind v. Comm'r* 73 T.C. 96 (1979). The charitable purpose was to provide employment for the blind and thus came within the regulations' statement that a charitable purpose includes "relief of the poor and distressed or underprivileged." *Id.* at 100-101. *See* Treas. Reg. 1.501(c)(3)-1(d).

⁴⁹ *Goldsboro Art League v. Comm'r*, 75 T.C. 337 (1980).

⁵⁰ *Elisian Guild, Inc. v. United States*, 412 F.2d 121, 125 (1st Cir. 1969).

endangering exempt status, although the income from these activities may in part be subject to taxation under the UBIT.⁵¹ Some recent private rulings, moreover, have reverted to commensurate-in-scope analysis, approving exemption for an organization that published textbooks for religious schools, even though revenues from the publishing business counted for over half of the organization's total revenues and enjoyed 75% profit margins;⁵² for an organization that helped developmentally disabled children, despite receiving 98% of its gross income from bingo games;⁵³ and for an organization formed to give financial assistance to needy women that produced 66% of its revenues from the operations of a gift shop and tea room.⁵⁴ Nevertheless, the IRS has continued to push the

⁵¹ See generally Virginia Richardson, Roderick Darling and Marvin Friedlander, *Health Clubs* in INTERNAL REVENUE SERVICE, EXEMPT ORGANIZATIONS CONTINUING PROFESSIONAL EDUCATION (CPE) TECHNICAL INSTRUCTION PROGRAM FOR FISCAL YEAR 2002 (2001) (operation of health club by university or hospital generally does not affect exempt status; income from memberships sold to general public – as opposed to students and faculty or patients and staff – generally taxable under UBIT).

⁵² Tech. Adv. Mem. 9636001, 1996 P.L.R. LEXIS 1026 (January 4, 1996). The organization started its publishing activities to supply its own schools with textbooks, but soon expanded to provide religious-oriented textbooks to schools worldwide. Revenues from the publishing business constituted over half the total gross revenues of the organization, and its profit margins were as high as 75%, though expenditures on the publishing business were less than half the organization's total expenditures. Finding that the publishing activities were virtually indistinguishable from those of a commercial religious publisher and that they were not "substantially related" to the educational activity of operating its own religious schools, the Service concluded that the profits of the activity were subject to the UBIT. At the same time, however, the Service concluded that the obviously-substantial nature of the publishing business did not endanger the taxpayer's exempt status because "there is no evidence that any of the funds generated by [the publishing business] were not properly used to further the organization's education purposes in some manner." *Id.* at *25. Accordingly the taxpayer was entitled to exemption "because it is carrying on an exempt program commensurate in scope with its financial resources." *Id.* at *25-26.

⁵³ Tech. Adv. Mem. 9711003 (Nov. 8, 1995) reprinted in 16 Exempt Org. Tax Rev. 626 (1997). See D. Benson Tesdhal, *Letter Ruling Alert: IRS Applies Liberal Primary Purpose and Commensurate Tests*, 16 EXEMPT ORG. TAX REV. 617 (1997). The organization represented that 50% of its time and resources were dedicated to bingo games, although over 95% of its gross income was used for bingo operations; expenditures on charitable activities ranged from about 1.5% to 3.5% during the years in question. Nevertheless, the IRS summarily dismissed the notion that this organization had any "commensurate" problems, noting that for 30 years the organization had been assisting developmentally disabled children and spent over 40% of its time and resources doing so. Accordingly, the commensurate-in-scope test "would not be applicable since the Association has a substantial charitable program in addition to its fundraising activities." *Id.* at 628. In the ruling, the IRS noted that although income from bingo games was specifically excluded from the UBIT in I.R.C. Section 513(f), that exclusion "was not intended to result in exemption for organizations whose primary activity is the conduct of bingo. Bingo remains an activity unrelated to exempt purposes and alone cannot support exemption . . ."). *Id.* at 627.

⁵⁴ Priv. Ltr. Rul. 200021056, 2000 P.L.R. LEXIS 562 at *33 (Feb. 8, 2000). The Service in this ruling reasoned that an unrelated business that is used as a "fundraiser" for an overall charitable

“commercial hue” test in litigation,⁵⁵ and several recent applications for exempt status have been rejected by the IRS on grounds that the organization’s activities were no different from commercial enterprises.⁵⁶

In short, the Treasury Regulations, IRS interpretations and litigating positions, and court cases all seem to be inconsistent in judging when commercial activity should result in loss of exempt status. In particular, neither the IRS nor the courts have analyzed consistently the main issue raised by the regulations: when (unrelated) commercial activity will be considered “in furtherance of” an exempt purpose as opposed to simply “primarily” operating an unrelated business.

B. Complex Structures

The conflict between “relatedness” and “in furtherance of” is not the only inconsistency in the commercial activity realm. IRS positions on how complex structures affect exempt status are also conflicting. In general, the IRS adheres to the view that corporate entities “stand on their own” for tax exemption purposes – that is, the activities (charitable or commercial) of one corporate entity will not be imputed to a related entity for either good (obtaining exempt status) or ill (revoking exemption). This “separate corporate identity” rule is a long-standing feature of corporate tax law, where treating an entity as a bona-fide, separate business container is necessary to protect the corporate tax base.⁵⁷ When it

purpose was operated “in furtherance of” a charitable purpose and did not constitute a substantial nonexempt purpose. *Id.* (“One way in which a trade or business may be in furtherance of exempt purposes is to raise money for the exempt purposes of the organization, notwithstanding that the actual trade or business activity may be taxable under sections 511 through 513.”) Similarly, in Field Service Advice memo 199910007 (Nov. 24, 1998); 1998 FSA LEXIS 15, the Service concluded that an organization operating a sports tournament whose net proceeds were turned over to another charity met the commensurate-in-scope requirement. For additional analysis of the checkered history of the commensurate-in-scope test, see Evelyn Brody, *A Taxing Time for Bishop Estate: What is the I.R.S. Role in Charity Governance?*, 21 U. HAW. L. REV. 537, 575-76 (1999).

⁵⁵ E.g., *Airlie Foundation v. I.R.S.*, 283 F. Supp. 2d 58 (D.D.C. 2003) (organization that rented conference facilities to other charities and helped with conference logistics not exempt because its activities were conducted in a commercial manner). The most recent example is

⁵⁶ E.g., Priv. Ltr. Rul. 200704041, 2006 PLR LEXIS 2448 (Oct. 30, 2006) (organization that provided down payment assistance to HUD-qualified home buyers not exempt; “The manner in which you operate your down payment assistance program indicates that you facilitate the sales of homes in a manner that is indistinguishable from an ordinary trade or business.”); Priv. Ltr. Rul. 200651037, 2006 PLR LEXIS 2020 (Sept. 28, 2006) (organization formed to sell items for individuals and transfer proceeds to charity of individual’s choice was performing services as agent for donor “which are characteristic of a trade or business and ordinarily carried on by for-profit commercial businesses.”).

⁵⁷ *Moline Properties v. Commissioner*, 319 U.S. 436 (1943). In *Moline Properties*, the taxpayer argued that a corporation which sold certain real estate should be disregarded, and the proceeds of sale taxed directly to the corporation’s sole shareholder. The Supreme Court ruled that the tax system must respect the separate identity of a corporation formed for a valid business reasons, thus

comes to joint ventures conducted in a partnership form (or in a limited liability company taxed as a partnership), however, the IRS position is that the partner is deemed to be in the same trade or business as the partnership – that is, the partner is deemed to be conducting directly the business of the partnership.⁵⁸ This “aggregate” view of partnerships is also a long-standing rule of general tax law.

In one sense, therefore, the IRS has been perfectly consistent in adopting for tax exemption the same rules that apply in general tax law regarding the “separate-ness” of entities. In a larger sense, however, these rules mean that the effects of a particular business activity on exemption and the potential that such activity will be taxed can be dramatically altered by the form of the “container” in which the business is conducted. For example, under current rules, an exempt entity could sit at the top of an extensive for-profit corporate business pyramid, and the corporate isolation rule would mean that the exempt parent would be essentially immune from claims that the overall activities of the “group” were not charitable.⁵⁹ By comparison, a charity that operated a substantial business

protecting the integrity of the corporate income tax. In General Counsel’s Memorandum 39326 (Jan. 17, 1985), the IRS applied the *Moline Properties* doctrine in assessing the exempt status of a nonprofit parent that owned a for-profit subsidiary, concluding that the subsidiary’s activities would not be imputed to the nonprofit parent. *See generally*, Colombo, *Commercial Activity*, *supra* note 8, at 515. For an extended discussion of the *Moline Properties* doctrine in the context of tax exemption, see HILL AND MANCINO, *supra* note 7, at ¶ 27.02.

A subsidiary corporation of an exempt parent can sometimes claim tax exemption as an “integral part” of the parent’s exempt activities. In general, the IRS position is that the “integral part” test is available only to “captive” subsidiaries that perform services exclusively for the exempt parent, such as a subsidiary that generates electrical power for its parent. Treas. Reg. § 1.502-1(b). For general discussions of the integral part doctrine, see John D. Colombo, *The IHC Cases: A Catch-22 for Integral Part Doctrine, A Requiem for Rev. Rul. 69-545*, 34 EXEMPT ORG. TAX REV. 401 (2001); HILL AND MANCINO, *supra* note 7 at ¶ 27.04.

⁵⁸ See, e.g., Rev. Rul. 98-15, 1998-1 C.B. 718, 720-721.

⁵⁹ One private ruling issued in 2004 suggests (in the mode of the “commensurate in scope” doctrine discussed above) that an exempt parent must somehow use revenues or assets of its for-profit subsidiaries to further its charitable purpose, or else it may run afoul of the primary purpose test. In TAM 200437040, the IRS examined whether large accumulations of value in a for-profit subsidiary of an exempt church would result in loss of exempt status. While the IRS ruled that it would not under the particular facts presented, its analysis suggests an ongoing obligation for an exempt parent to use revenues/assets from a for-profit subsidiary to expand charitable outputs, and the commensurate in scope doctrine. In this private ruling the IRS stated:

In post-audit years, it appears that the subsidiary grew rapidly -- perhaps beyond X's expectations. It is now worth several times X's investment in the subsidiary, although it apparently had not earned an operating profit through * * *. This growth presents a continuing obligation on X to translate this valuable asset into funds, and use those funds for the expansion of its charitable religious activities. For example, X may have to give consideration to selling some of the subsidiary's assets, or selling a portion of the stock of the subsidiary, to an unrelated party. The proceeds of such transactions must be used to fund or expand X's charitable or religious activities. The subsidiary should give highest

enterprise via a partnership would place its exempt status at risk under the current version of the commerciality doctrine described above.⁶⁰ At the same time, an exempt organization that isolated a particular business activity in a corporate container for regulatory or liability reasons would lose any possibility of arguing that the business was “related” to the exempt organization’s charitable purpose, since the parent’s charitable activities could not be attributed “downstream” to the subsidiary corporation.⁶¹ At one time, even the Treasury itself questioned the wisdom of these rules,⁶² although there are no current legislative proposals to change them.

C. Private Benefit

The final issue that comes up repeatedly in the commercial-activity sphere is the private benefit doctrine. Even trying to summarize the private benefit doctrine is hazardous, but from a variety of IRS rulings and litigated cases, one might conclude that private benefit is a benefit (usually economic) that flows to some person or entity outside the charitable class as a result of serving the charitable

priority to repaying X's investment loans once it begins generating cash flow or earnings and profits, so that these funds can be used for X's charitable or religious activities. X cannot be allowed to focus its energies on expanding its subsidiary's commercial business and assets, and neglect to translate that financial success into specific, definite and feasible plans for the expansion of its charitable religious activities. . . .

The fact that the assets are being accumulated in a for-profit company under the formal legal control of X does not excuse X from using such assets for charitable religious purposes.

Tech. Adv. Mem. 200437040, 2004 PLR LEXIS 612, *25-*26 (June 7, 2004).

⁶⁰ See text at notes 19-56, *supra*.

⁶¹ For example, we know from recent case law that a contract-model health maintenance organization (HMO) will find it difficult to obtain exemption under 501(c)(3) if the HMO business is in a separate corporation. See, e.g., *IHC Health Plans v. Comm’r*, 325 F.3d 1188 (10th Cir. 2003). It is not clear, however, whether revenues from an HMO that was operated as a “division” of a nonprofit corporation that operated an exempt acute-care hospital would be taxable or not; one could certainly argue that such revenues are “substantially related” to the hospital’s exempt purpose of providing health care for the general benefit of the community, although some older IRS rulings suggest that if a hospital receives revenues from persons other than hospital patients, such revenues would be “unrelated.” See, e.g., Gen. Couns. Mem. 39830 (Aug. 30, 1990) (suggesting that an HMO might be considered an unrelated business in the hands of a hospital corporation since the HMO provides services to persons not patients of the hospital).

⁶² As part of hearings on the UBIT in the late 1980’s (hereafter, “the Pickle hearings”) the Oversight Subcommittee of the House Ways and Means Committee circulated a draft report that recommended aggregating the activities of a parent nonprofit and any 80%-owned subsidiary for purposes of applying the “primary purpose” test of exemption. See generally, HILL AND MANCINO, *supra* note 7, ¶27.03[4]; Aprill, *supra* note 24, at 1106; Evelyn Brody, *Business Activities of Nonprofit Organizations: Legal Boundary Problems in* CORDES AND STEURLE, *supra* note 6.

class. Whether such a benefit creates exemption problems is judged on a balancing test. The best statement we have from the IRS regarding the doctrine comes from a 1987 General Counsel’s Memorandum, which stated:

An organization is not described in section 501(c)(3) if it serves a private interest more than incidentally. . .

A private benefit is considered incidental only if it is incidental in both a qualitative and a quantitative sense. In order to be incidental in a qualitative sense, the benefit must be a necessary concomitant of the activity which benefits the public at large, i.e., the activity can be accomplished only by benefiting certain private individuals. . . . To be incidental in a quantitative sense, the private benefit must not be substantial after considering the overall public benefit conferred by the activity.⁶³

Although the IRS has used the private benefit doctrine in a wide variety of contexts, it has been a particular fixture of IRS analysis of commercial transactions undertaken by exempt charities with for-profit entities or individual investors. Thus the IRS has applied the concept to partnerships between hospitals and doctors;⁶⁴ low-income housing partnerships with private investors;⁶⁵ “down-payment assistance” programs in which a charity acts as an intermediary between a real estate developer and a potential charitable client⁶⁶ and similar transactions.⁶⁷ Because of the breadth of the doctrine as currently applied by the IRS, any significant economic transaction between an exempt charity and a non-exempt entity or individual outside the charitable class is subject to private benefit attack, and the balancing approach means that the line between permitted and problematic private benefit is unclear.⁶⁸

⁶³ Gen. Couns. Mem 39598 (Jan. 23, 1987).

⁶⁴ E.g., Gen. Couns. Mem. 39862, 1991 IRS GCM LEXIS 39 (Nov. 22, 1991).

⁶⁵ See, e.g., Jerry O. Allen and Alan D. Duffy, *Solving the Low-Income Tax Credit Housing Partnership Dilemma*, 49 EXEMPT ORG. TAX REV. 319 (2005); J. Christine Harris, *Tax-Exemption And Low-Income Housing Ventures: Irreconcilable Differences?* 47 EXEMPT ORG. TAX REV. 329 (2005); J. Christine Harris, *Tax Law Professors Say Recent Joint Venture Ruling Doesn't Break Ground In Housing*, 47 EXEMPT ORG. TAX REV. 21 (2005); Michael I. Sanders and Celia A. Roady, *EO Practitioners Suggest Way To Expedite Exemptions For Low-Income Housing Orgs.*, 37 EXEMPT ORG. TAX REV. 127 (2002).

⁶⁶ E.g., Rev. Rul. 2006-27, 2006-21 I.R.B. 915.

⁶⁷ See generally, John D. Colombo, *In Search of Private Benefit*, 58 FLA. L. REV. 1063 (2006).

⁶⁸ In 2004, the IRS did clarify that certain “ancillary” partnerships between an exempt charity and a for-profit company would not create private benefit problems, though the ruling is largely devoid of analysis and leaves open as many questions as it answers. Rev. Rul. 2004-51, 2004-22 I.R.B. 974. See generally, Colombo, *supra* note 66, at 1077-79; J. Christine Harris, *Tax Law Professors*

III. Making Tax Law Coherent

A. *A Taxonomy of Commercial Activity and the Policy Objectives of Regulating It*

Part II. above recounts the inconsistent positions the IRS and courts have taken with respect to whether commercial activity should affect exempt status. In order to get a handle on the issues involved and how best to revise federal tax law on this front, it may be helpful to think about how different kinds of commercial activity impact policy objectives relating to such activity.

In some prior writing, I identified several policy concerns with charities conducting commercial activities. Those concerns are (1) avoiding unfair competition between exempt and for-profit entities, (2) limiting erosion of the corporate tax base by having charitable organizations buy taxable activities that become non-taxable in the charity's hands, (3) limiting the extent to which the attention of management is "diverted" from charitable activities into running for-profit businesses, (4) promoting economic efficiency, (5) guarding against "over-subsidizing" charitable activities by letting charities "self-subsidize" through the acquisition of commercial businesses, and (6) limiting the business risk exposure of charitable assets that might accompany running a business from the same "container" (corporation or trust) that houses charitable assets.⁶⁹ Some of these policy concerns are more significant than others. For example, economists have almost uniformly rejected the notion that charities engage in unfair competition, at least if that phrase is limited to predatory pricing techniques or inappropriately using exempt revenues to subsidize commercial activity.⁷⁰ Similarly, exposing charitable assets to business risk can best be handled through insurance and proper diversification; tax law should have little to say about this policy issue.⁷¹ On the other hand, protecting the corporate tax base, limiting managerial diversion, promoting economic efficiency and limiting possible over-subsidization of charitable activities (which could be viewed as simply a subset of promoting economic efficiency) do seem to be significant concerns.

Say Recent Joint Venture Ruling Doesn't Break Ground In Housing, 47 EXEMPT ORG. TAX REV. 21 (2005).

⁶⁹ Colombo, *Commercial Activity*, *supra* note 8, at 529-546.

⁷⁰ *Id.* at 530. See also, Michael S. Knoll, *The UBIT: Leveling and Uneven Playing Field or Tilting a Level One*, 76 FORDHAM L. REV. 857 (2007) (questioning whether there is any economic advantage to a nonprofit engaging in a commercial business).

⁷¹ *Id.* at 544-46.

Commercial activity also has its benefits, however. The obvious benefit is that it permits charitable organizations to expand (or maintain) their outputs in an environment in which the availability of direct government grants may be shrinking and competition for both the available government money and private donations is increasing exponentially along with the sheer numbers of exempt charities.⁷² In some cases, moreover, commercial activity may permit a charity to earn a return on capital investments made primarily for charitable purposes, but which by their nature may be under-utilized for purely charitable outputs. Thus a conclusion that commercial activity by exempt charities is uniformly “bad” is not correct.

Instead, it may be useful to try to categorize the kinds of commercial activities charities engage in and analyze whether the concerns with commercial activity outweigh the potential benefits. In general, one can separate commercial activity into five categories:

- *Category 1:* commercial activity that is also the primary exempt activity;
- *Category 2:* commercial activity that is functionally related to the organization’s exempt purpose (e.g., “substantially related” activity under the UBIT);
- *Category 3:* “unrelated” commercial activity that exploits excess capacity;
- *Category 4:* “unrelated” commercial activity that does not exploit excess capacity but the revenues from the activity are directed to charitable outputs, and
- *Category 5:* “unrelated” commercial activity that becomes “empire building” for its own sake.⁷³

Scripture Press, discussed above, is a classic example of a Category 1 case, because religious publishing was the taxpayer’s only activity. Other examples exist, however. There is little doubt that a nonprofit hospital, selling health care services for a fee at prices virtually identical to for-profit hospitals in similar markets is engaged in commercial activity that is also its primary activity; in this case, however, the specific commercial activity has been approved (under the correct ancillary conditions)⁷⁴ as a primary charitable activity. Low-income housing partnerships are another example of a charitable organization engaging in

⁷² See Burton A. Weisbrod, *The nonprofit mission and its financing: Growing links between nonprofits and the rest of the economy*, in TO PROFIT OR NOT TO PROFIT, *supra* note 5, at 1, 2-7.

⁷³ See Colombo, *Commercial Activity*, *supra* note 8, at 525-529. The “empire building” concern is what led Treasury to propose an aggregation rule for determining if a particular nonprofit had a “primary” charitable purpose in the Pickle hearings in the late 1980’s. See note 62, *supra*; Brody, *supra* note 62, at 32.

⁷⁴ See, e.g., *IHC Health Plans, Inc. v. Comm’r*, 325 F.3d 1188 (2003); John D. Colombo, *The Failure of Community Benefit*, 15 HEALTH MATRIX 29, 30-37 (2005).

a commercial enterprise (building and renting housing) as its primary charitable activity. In these cases, therefore, the key question is whether the activity undertaken by the nonprofit will be considered charitable in itself. If so, there is nothing more to discuss; if not, then the organization presumably falls into the category of Treasury Regulations 1.501(c)(3)-1(e)(1) of operating an “unrelated” business as its primary purpose, and thus fails the tests for exemption.⁷⁵

Categories 2-5 involve inherently different circumstances. In each of these categories, the charity has a substantial charitable activity of some kind that exists alongside the commercial activity. In Category 2, the commercial activity is one that is functionally related to the charity’s exempt purpose – activity which would be “substantially related” under the current UBIT. Such related activities may be a concern for tax-base erosion, but little else. Since the activities are functionally related to the exempt purpose they bear little risk of managerial diversion (after all, management is engaging in these activities as an integral part of their exempt activities). Moreover, as Professor Henry Hansmann has noted, these activities raise few, if any, economic efficiency problems since one would assume these activities involve some kind of economies of scope (e.g., the capital asset has already been purchased or employees are already trained to do these activities).⁷⁶

⁷⁵ This category is one where confusion over the difference between charitable purpose and charitable activities is most problematic. One might argue, for example, that a nonprofit pharmacy has a charitable purpose to promote health; *see, e.g.*, Rev. Rul. 69-545, 1969-2 Cum. Bull. 117 (promotion of health for the general benefit of the community is a charitable purpose). If none of its activities can be classified as charitable, however, then it seems obvious that its *primary* purpose is not charitable but something else. *See, e.g.*, *Federation Pharmacy Services v. Comm’r*, 625 F.2d 804 (8th Cir. 1980) (nonprofit pharmacy not exempt because activity of selling drugs at cost to elderly and poor is a commercial activity, not a charitable one; pharmacy not eligible for exemption). Similarly, this conflation of charitable purpose and charitable activities can explain the different results in the *Scripture Press* and *Presbyterian and Reformed Publishing Cases* discussed above. In *Scripture Press*, the Claims Court appeared to view religious publishing as not being a charitable activity, at least when conducted with a “commercial hue,” despite the fact that publishing religious texts would seem to functionally advance a charitable purpose of promoting religion. In contrast, the Third Circuit in *Presbyterian and Reformed Publishing* clearly did view religious publishing as a charitable activity that promoted a religious purpose.

In PLR 200818023 (released Feb. 6, 2008), the IRS came as close as it has in 40 years to properly analyzing the effect of commercial activity on exempt status. In this ruling, the Service analyzed the case of an organization primarily selling certain types of securities for a fee to facilitate estate planning, with about .5% (one half of one percent) of the fees going to charity. The IRS concluded that the security sales were inherently commercial, and that the .5% of revenues going to charity did not pass muster under the “commensurate in scope” doctrine. This in turn meant that the taxpayer’s “primary purpose” was operating an unrelated business, because the securities sale activity was not “in furtherance of” a charitable purpose. The ruling created something of a stir among charities after the then-head of TE/GE, Mike Miller, opined that the commensurate test might be used to regulate how charities were using their resources.

⁷⁶ Henry Hansmann, *Unfair Competition and the Unrelated Business Income Tax*, 75 VA. L. REV. 605, 626-28 (1989).

For example, one would expect that the music school that puts on concerts by by for-profit groups already has personnel experienced in concert planning and execution. There may be some risk of undue “self-subsidization” by charities if these related activities are financially successful, but given that these activities are by definition a functional part of the charitable program, the chances of these activities becoming serious money-makers likely are small.

In Category 3, charities undertake “unrelated” commercial activities because they have excess capacity from capital investments made for charitable purposes. The classic example here is a university that rents its stadium facilities to a professional football team for the summer or that leases unused supercomputer time to for-profit research groups.⁷⁷ Commercial activities falling within this category also should not raise exemption problems. In this kind of case, we should positively encourage charities to avoid letting assets simply lie fallow. Doing so is a waste of invested capital. There may be some concern that we not encourage charities to consciously “over-invest” in capital facilities or in employees simply to use them in commercial businesses, but to the extent that investments are made at a level necessary to conduct charitable activities, earning a profit through maximum utilization of that investment would seem to be a desirable and efficient outcome. Moreover, if the capital investment is made in the first instance to pursue charitable activities, there is little reason to think that there is much risk to the corporate tax base (since the activities for which the investment was made likely would not have been undertaken by the private market). Managerial diversion also would be limited, because if the capital assets used in the commercial activity were primarily meant for charitable purposes, any commercial activity by definition will be subordinate to commercial use. For example, the empty athletic stadium is only available to rent when the university’s teams are not using it – generally, this means the summer only. Ditto for the unused supercomputer time – commercial use will by necessity be subordinate to academic use.

In Category 4, charities undertake commercial activities that do not exploit economies of scope, but generate returns above the market rate on stocks and bonds that in turn will be used to expand charitable outputs. The church that opens a Starbucks franchise probably has no significant economies of scope to exploit in that activity, but may (in some cases correctly) conclude that investing in the Starbucks will produce a rate of return significantly higher than a diversified portfolio of stocks and bonds. There may be programmatic reasons as well: luring former church-goers back to Sunday services with the promise of good coffee, or trying to expand the number of patrons of the local museum by having after-hours cocktail parties.

⁷⁷ See Hansmann, *supra* note 76, at 627, 628.

These Category 4 activities raise mixed issues. On the one hand, it seems that we should not impede the ability of charities to develop alternative resources to expand charitable outputs. Other commentators have noted the modern pressures on funding sources for charities;⁷⁸ if investing wisely in certain commercial activities produces a premium rate of return for charities to expand charitable outputs, that seems as though it would be a generally good thing. Engaging in these activities, therefore, likely should not affect exempt status as long as the revenues from the commercial activity are used to subsidize charitable outputs. Yet there are some countervailing concerns. Unlike category 2 or 3 activities, those in category 4 are far more likely to result in managerial diversion, since the commercial activity is not subordinate to any charitable use of the underlying assets. The church that runs a Starbucks to supplement the collection plate will almost certainly need to invest significant managerial time in running the Starbucks. Category 4 activities also raise questions of protecting the corporate tax base, economic efficiency and over-subsidization, particularly if these activities are not subjected to the general corporate income tax. If these activities are not taxed, charities can earn a premium rate of return on them simply because they can avoid the corporate-level tax, not because managerial or other efficiencies produce a premium rate of return.⁷⁹ Thus, failing to tax these activities would encourage charities to invest money in direct commercial activities even if such activities would be “worse” investments on an after-tax basis than a diversified portfolio. This incentive would in turn result in more such activities undertaken by charities, withdrawing those assets from the corporate tax base (the tax-base protection issue), and would result in charities essentially “self-subsidizing” their operations even if doing so resulted in an oversupply of the particular charitable good or service that the commercial activity was subsidizing. The proper policy response to category 4 activities, therefore, would seem to be to tax them, but not have them affect underlying exempt status.

Finally, in Category 5, charities become involved in commercial activities that take on a life of their own, where revenues are largely reinvested in the activity itself, instead of being used to subsidize expanding charitable outputs. In a 2004 Technical Advice Memorandum dealing with an exempt church that owned a for-profit subsidiary, the IRS raised precisely these empire building concerns, cautioning the exempt parent that it “cannot be allowed to focus its energies on expanding its subsidiary’s commercial business and assets, and neglect to

⁷⁸ See Weisbrod, *supra* note 72.

⁷⁹ Corporations pay entity-level tax on their earnings at a maximum rate of 35%, whereas proprietorships and partnerships (or LLC’s that choose to be taxed as partnerships) pay no entity-level tax. That means that in theory, a corporation must earn a higher pre-tax return on equity to compete with other investments in the market on an after-tax basis. If a charity could acquire a corporate business and avoid the corporate-level tax, it would be able to capture this higher pre-tax rate of return for itself simply as a result of the ownership change.

translate that financial success into specific, definite and feasible plans for the expansion of its charitable religious activities.”⁸⁰ One might argue that Division I college basketball and football programs may also present these problems, at least in individual cases. Recent headlines such as Alabama’s hiring of Nick Saban for \$32 million over eight years⁸¹ surely make one wonder whether Alabama is rationally seeking to maximize football revenues to subsidize other charitable (e.g., educational) outputs, or whether running a successful Division I football program has simply become an end unto itself. In these cases, management of the charity may need a forceful reminder of its underlying mission – and there is no more forceful reminder than the threat of losing tax exemption.⁸²

B. Suggested Reforms

The above analysis suggests some reforms that may be worthy of consideration. First, the problem with Category 1 cases is really a problem with defining appropriate charitable activities, not a problem of the relationship between charitable activities and commercial ones. What is necessary here is that the IRS adopt a consistent approach to analyzing Category 1 cases. Perhaps that consistent approach could be something along the following lines: if an organization’s sole activity (ignoring *de minimis* activities) is one that is commercial, exemption will be denied. One can imagine that the “commercial hue” test adopted by the courts would have a place in this analysis as a method of determining whether the sole activity is a commercial one or not.

Of course, this approach would create a few problems with some existing organizations. If publishing religious texts in a manner similar to commercial publishers is not charitable, then one wonders why operating a hospital in a manner similar to for-profit hospitals justifies exemption. I certainly have no problem with the IRS taking the position that no commercial activity can support exemption standing alone⁸³ (e.g., apart from cases in which the commercial revenues are used to support some other charitable activities), but if that is going to be approach, it needs to be applied consistently.

⁸⁰ Tech. Adv. Mem. 200437040, 2004 PLR LEXIS 612, *25-*26 (June 7, 2004).

⁸¹ See, Jodi Upton, *Saban's contract could bring congressional inquiry*, USA Today, available at http://www.usatoday.com/sports/college/football/sec/2007-01-03-saban-contract_x.htm

⁸² Of course, if one believes that big-time college football and basketball programs are themselves charitable activities, then this example is really a Category 1 case, not a Category 5 case. An issue that arises with the analysis in the text is exactly how one distinguishes between a “commercial” activity and a “charitable” activity that produces revenue. For a discussion of this issue, see text at notes 91-92, *infra*.

⁸³ I have in the past suggested that tax exemption is appropriate only in cases of combined market failure and government failure; if a “charity” is engaged in an activity that is simply participating in a private market, there is no market failure and no need for exemption. See *generally*, JOHN D. COLOMBO AND MARK A. HALL, *THE CHARITABLE TAX EXEMPTION* (1995).

Categories 2, 3, 4, and 5, on the other hand, all presuppose that the organization in question has *some* charitable activities apart from its commercial activity. Of these, only Category 5 activity should result in loss of tax exemption. These “empire building” cases present the greatest threat of managerial diversion and of nonprofits becoming for-profits in disguise. Accordingly, exemption should be at risk only in cases in which the commercial activity is not functionally related to the organization’s exempt purpose *and* revenues from commercial activity are not used to substantially cross-subsidize charitable outputs. Put another way, the IRS needs to make clear that the key concept in the regulations on this issue – the “in furtherance of” concept – can mean *either* that the activity is functionally related to an exempt purpose (e.g., “substantially related” as defined in the UBIT) or else that the activity provides revenues to subsidize other charitable outputs (in effect, a retention for exemption purposes of the “destination of income” test). As noted below, this approach is completely consistent with taxing commercial revenues under the current or an expanded UBIT; the “in furtherance of” concept relates only to exempt status.

A second suggested reform, therefore, is for either Congress or the IRS to formally resurrect the 1964 version of the commensurate in scope doctrine; that is, either an amendment to Section 501 or new regulations or a new Revenue Ruling that makes clear that as long as revenues from commercial activities are being used to conduct a substantial charitable program, the activity will be considered “in furtherance of” an exempt purpose and the organization’s tax exempt status is not at risk. One possible refinement to the commensurate in scope test would be to provide a safe-harbor provision for exactly how much subsidy a commercial business must provide to charitable activities to avoid exemption issues. I have previously suggested that one might use the short-term or mid-term Applicable Federal Rate as a safe-harbor rate of return for this purpose – for example, if the short-term AFR is 4%, then a charity would know that if a commercial activity provided at least a 4% return used to subsidize charitable activities, the commensurate-in-scope test would be met automatically, and no exemption issues would arise from operating this commercial activity.⁸⁴

A third reform would be to jettison the relatedness test for the UBIT and impose tax on all commercial activities by charities, whether related or not.⁸⁵

⁸⁴ Colombo, *Commensurate-in-Scope*, *supra* note 8, at 351.

⁸⁵ This proposal is not new. The idea of replacing the “substantially related” test with a “commerciality” test stretches back at least to the Pickle hearings by the Oversight Subcommittee of the House Ways and Means Committee in the late 1980’s. Brody, *supra* note 62, at 32-34. *See also*, James Bennett and Gabriel Rudney, *A Commerciality Test to Resolve the Commercial Nonprofit Issue*, 36 TAX NOTES 1095 (1987). The proposed rationale for this reform at the time, however, was to prevent “unfair competition” by nonprofit charities, which to the small business

There are several reasons for this approach. First, the analysis in Part III.A. indicates that while commercial activity in categories 2, 3 and 4 should not affect exemption, such activities (particularly those in category 4) do present some significant risks to the corporate tax base, of managerial diversion, and of economic inefficiency and excessive self-subsidization. Taxing all commercial activities obviously would more completely protect the corporate tax base than the current system, since no commercial activity (even if it is “related”) would escape taxation. Second, taxing all commercial activity would promote economic efficiency, because charities could not earn a premium rate of return on a particular activity simply by avoiding the income tax that would otherwise be due. Under this proposed system, a charity presumably would choose to invest in a direct commercial activity only if the after-tax rate of return it could earn would be greater than the market rate on a diversified portfolio of investment assets – that is, the charity would have to make a decision that it could earn a premium rate of return by efficient operation of the commercial enterprise, and not just by avoiding taxes.⁸⁶ It is likely, therefore, that if all commercial activity were taxed, charities would concentrate on commercial activities for which they enjoy some economies of scope with respect to either capital investments or employees or which had some other kind of synergy with their charitable programs, which in turn would also help curb empire-building tendencies and avoid managerial diversion issues.⁸⁷ Finally, this approach would actually simplify the law – we would no longer rely on tortured interpretations of the phrase “substantially related” to determine if a commercial activity is taxable or not; and if all such activities are taxable, the “container” used to conduct them would be irrelevant.

The fourth potential reform follows from the second and third. If commercial activity is essentially unlimited provided that it is used by the exempt organization as a source of funding for charitable outputs and if all commercial activity is

community, really meant “any competition.” As noted in the text, several other policy concerns present better rationales for taking this step.

⁸⁶ See Hansmann, *supra* note 76, at 627. Taxing all commercial activity also should satisfy Susan Rose-Ackerman’s concern that the current system distorts economic activity by encouraging nonprofits to invest more in related than unrelated activity. Susan Rose-Ackerman, *Unfair Competition and Corporate Income Taxation*, 34 Stan. L. Rev. 1017, 1038 (1982). Rose-Ackerman suggested getting rid of the UBIT because of this distortion, but subjecting all commercial activity to tax should also eliminate this problem.

⁸⁷ Making all commercial activities subject to taxation, rather than just “unrelated” activities, might also reduce the ability of charities to “game the system” by allocating costs from charitable and related businesses to “unrelated businesses,” thereby reducing (often eliminating) any tax liability for unrelated activities. See, e.g., Evelyn Brody, *Charities in Tax Reform: Threats to Subsidies Overt and Covert*, 66 TENN. L. REV. 687, 733 (1999); Joseph J. Cordes & Burton A. Weisbrod, *Differential Taxation of Nonprofits and the Commercialization of Nonprofit Revenues*, in TO PROFIT OR NOT TO PROFIT, *supra* note 5, at 97-100; Robert J. Yetman, *Tax-Motivated Expense Allocations by Nonprofit Organizations*, 76 ACCT. REV. 297 (2001).

taxed, then there is no tax reason to distinguish between the activities of different pieces of a complex enterprise for tax exemption purposes. That is, whether a specific nonprofit within a related group of organizations meets the “primary purpose” test for exemption should be tested based upon the aggregate activities of a complex group, not on an entity-by-entity basis.⁸⁸ Either the group as a whole would have a “primary” charitable purpose (and operating commercial businesses to fund this primary purpose would be perfectly OK under my proposals) or it does not. Exemption should follow this group analysis, and not rest upon arbitrary distinctions regarding the kind of economic container in which specific activities are carried out. Note, however, that if the first and second reforms suggested above are adopted, then the IRS should give exempt status rather freely: any nonprofit organization that can make a credible claim to a bona-fide, substantial charitable purpose should be granted exemption, since all of the commercial activities of that organization would be subject to taxation in any event.⁸⁹

Finally, the IRS desperately needs to better-define the role of the private benefit doctrine in policing exempt organizations, particularly in the realm of revenue-generating activities carried on in partnership with for-profit organizations or private investors. These transactions often are used to expand charitable outputs or as revenue-generators for exempt activities, and therefore should not automatically be subject to private benefit attack. I have recently suggested that private benefit should be used by the IRS to guard against transactions in which charities arguably “waste” charitable resources, primarily in transactions in which a charity “outsources” core services or enters into long-term contracts with for-profit entities that confer a competitive advantage on the for-profit.⁹⁰ Limiting private benefit in this manner would make clear that economic transactions with for-profit entities that enhance a charity’s ability to serve its charitable class (a feature of many partnership transactions that the IRS has viewed dimly in the past) are not exemption problems.

The reforms suggested here, however, are dependent on a final issue: being able to distinguish revenue-producing charitable activities from commercial ones. If a nonprofit theater sells tickets to the public, is the ticket revenue from a

⁸⁸ Once again, this proposal is not new and harkens back to the Pickle hearings of the late 1980’s. The Treasury proposal at that time suggested aggregation for 80%-owned subsidiaries; see note 62, *supra*. I have suggested a far broader test of aggregation based upon the “supporting organization” tests in I.R.C. § 509(a)(3). Colombo, *Commercial Activity*, *supra* note 8, at 565.

⁸⁹ I do not mean to suggest here that for-profit entities in a complex structure would somehow be converted for tax purposes to nonprofit status. Rather, I mean only that any nonprofit organizations in a complex structure would be tested for its “primary purpose” based upon the activities of the group as a whole, and not on their individual activities.

⁹⁰ John D. Colombo, *In Search of Private Benefit*, 58 Fla. L. Rev. 1064, 1088-1090 (2006).

“commercial activity”? How about sales of drinks and food to theater patrons? For the answer, we should turn back to the main policy issues surrounding commercial activity, including protecting the corporate tax base, managerial diversion and economic efficiency. In particular, it seems that if these are the main problems with charities engaging in commercial activity, then an activity should not be labeled “commercial” unless it is competing with substantially similar for-profit goods or services. An activity that would not be conducted in the for-profit market is not a worry for the corporate tax base, because no tax would be collected on that activity in any event. Nor would such an activity seem to be a managerial diversion concern – in fact, it seems that nonprofits should be providing exactly those services not part of the for-profit market. Finally, if the for-profit market can’t or won’t produce a particular good or service, then by definition there is no more efficient way to produce it than through the government or the nonprofit sector, and if the government won’t do it, that leaves only the nonprofit sector. Thus whether the theater’s ticket sales are a “commercial activity” or not should depend on whether the theater is producing the same kinds of plays as for-profit theaters and hence is competing in the for-profit theater market. Food and drink sales, on the other hand, are easy to classify as “commercial” since all sorts of for-profit restaurants, vending machine companies and so forth are in that same business.⁹¹ For cases in the middle, the “commercial hue” analysis developed by the courts and the IRS (but inappropriately applied to the decision to grant exemption)⁹² might be a good starting point for analyzing whether a particular activity is, in fact, a “commercial” one.

IV. Summary

As a policy matter, how the law regulates commercial activity by charities goes to the very heart of what the charitable sector will look like in the future.

⁹¹ Of course, as with all other legal tests, there will be inevitable disagreement at the edges. For example, are Division I college football and basketball “commercial” under this test? They certainly produce substantial revenues for their schools, but whether they compete with “substantially similar” for-profit goods and services (e.g., professional for-profit sports) is an open question. The Supreme Court, for example, has suggested in the antitrust context that NCAA football does not compete with professional football. See *N.C.A.A. v. Board of Regents*, 468 U.S. 85, 101-102 (1984). Tax law would not necessarily have to adopt precedents from antitrust law for this purpose. Particularly in light of the policy concerns of managerial diversion and economic efficiency, one could argue that the test for what is a commercial activity in the tax exemption world should be somewhat broader than what the courts may find to be competing products in the antitrust field. Viewing markets and competing goods narrowly in antitrust law generally has the effect of protecting competition, which is the purpose of antitrust law. Drawing similar narrow lines in exemption law does not similarly advance the policy concerns noted above with commercial activity by charities.

⁹² See text at notes 41-43, *supra*.

Unfortunately, the current provisions of the I.R.C. regarding commercial activity by charities and the IRS's and courts' interpretations of those provisions have created needless confusion and uncertainty, particularly regarding the effects of commercial activity on exempt status. While I have suggested some possible reforms above, even if one disagrees with the suggestions, it is certainly time for Congress to undertake a comprehensive review of these rules and enact provisions that embody a clear rationale with clear lines demarking appropriate and inappropriate activities.

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